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Proposals for the Improvement of Subchapter K

Federal Taxation Division

AUGUST 1979

AICPA American Institute of Certified Public Accountants
1620 Eye Street, N.W., Washington, D.C. 20006

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FOREWORD

Since the codification of the various regulations, rulings, and court cases in the 1954 Internal Revenue Code for the tax treatment of partnerships, many problems have arisen in application. In recent years, more attention is being focused on partnerships. The complexity of subchapter K, dealing with the tax treatment of partners and partnerships, has become increasingly apparent and significant.

With this complexity in mind, the AICPA Federal Taxation Division formed a task force to study the subject. The objectives were to propose changes that would reduce differences in tax treatment between partnerships and other entities and to propose recommendations which would serve to clarify and simplify some of the more troublesome subchapter K provisions. This report, then, represents the culmination of a four-year study, and its recommendations are organized in the following manner:

1. Proposed <u>substantive</u> changes in the Internal Revenue Code.
2. Proposed <u>substantive</u> changes in the Treasury Regulations.
3. Proposed <u>technical</u> changes in the Internal Revenue Code, including recommendations for clarification.
4. Proposed <u>technical</u> changes in the Treasury Regulations.
5. Proposed <u>administrative and clarification</u> changes.

Throughout the four years during which this study was prepared, there were significant changes in the partnership provisions of the Internal Revenue Code. The report includes comments regarding certain modifications adopted with the Tax Reform Act of 1976. However, because of the extensive nature of the 1976 provisions, there may be some recommendations which are not technically adjusted for the new provisions. This is especially the case where references to regulations occur which have not, as yet, been updated.

The AICPA Federal Taxation Division extends its appreciation to the members of the subchapter K task force

Sol Schwartz, Chairman
Morris Engel
Bernard Lemlech

for their time, effort, and dedication to this project. Their discussions and analyses have contributed to suggestions which should prove helpful in unraveling some of the complexity of this subject.

The recommendations presented have been approved by the taxation of special entities and industries subcommittee and the executive committee of the federal taxation division and therefore, reflect the position of the division and the American Institute of Certified Public Accountants. The members of these bodies in 1978, when the report was approved, were:

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PROPOSALS FOR THE IMPROVEMENT OF SUBCHAPTER K

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1. Section 702 - Statutory Limitations Applicable to Partner Level Rather Than Partnership Level.

Recommendation There should be no limitations imposed on a partnership regarding items of income, deduction and credit that have statutory limitations elsewhere in the code. Such limitations should apply only to the partners.

Discussion The regulations under sec. 702, in general, apply the aggregate theory. Regs. sec. 1.702-1(a)(8)(ii) states that each partner must also take into account separately his distributive share of any partnership item that, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

It would seem logical that where there are specific limitations on certain items of income, deduction, or credit, the aggregate theory should be followed consistently.

Following are examples of items to which the aggregate theory is applied currently:

- Investment interest limitation under sec. 163(d).
- Farm net losses under sec. 1251.
- Limitation on charitable contributions.

On the other hand, under sec. 48(c)(2)(D), the limitation on used property qualifying for the investment tax credit and the dollar amount of property qualifying for additional first-year depreciation under sec. 179 is imposed initially on partnerships.

We believe that in the interests of equity, consistency, and simplicity, this type of limitation should only be imposed on partners. This recommendation conforms with a provision of the Partnership Income Tax Revision Act of 1960, which was passed by the House as H.R. 9662. That provision, designated sec. 702(d), reads: "If any limitation on the amount of the exclusion or deduction of any item of income, gain, loss, or deduction affecting the computation of taxable income, or on the amount of any credit, is expressed in terms of a fixed amount, or a percentage of income, such limitation shall be applied only to the partner and not to the partnership."

2. Section 703 - Deficiency Elections for Partnerships.

Recommendation Sec. 703(b) should provide that elections permissible at the partnership level will be considered timely if made in connection with a determination that a partnership in fact exists, notwithstanding the failure to have made such elections on a timely filed partnership return.

Discussion Sec. 761 provides only a brief definition of a partnership. It is possible that an IRS examination may result in the determination that an operational format utilized by taxpayers was, in fact, a partnership under sec. 761. Where taxpayers have acted in good faith in reporting taxable income or loss predicated on the belief that a partnership did not exist, they should not be penalized for failure to make otherwise allowable elections on a partnership return. Accordingly, the concept of an elective deficiency remedy, similar in intent to that of sec. 547 and sec. 859 regarding deficiency dividends, should be made applicable under sec. 703(b). It should cover situations in which an IRS determination that a partnership exists would prevent elections at the partnership level that would otherwise have been valid if a timely partnership return had been filed.

Sec. 6698 added by the Revenue Act of 1978 provides a reasonable cause exception to the new penalty rules for failure to file a partnership return. Sec. 703(b) should be cross-referenced to sec. 6698, if it is deemed desirable to provide a statutory test for determining when a taxpayer acted in good faith. In addition, the commissioner should have the authority to grant permission to allow a deficiency election to any taxpayer who acted in good faith, even where the partnership fails to prove reasonable cause under sec. 6698.

3. Section 703(b) - Election to Reinvest Proceeds From Involuntary Conversion of Substantially All Partnership Assets to Be Made by Individual Partners.

Recommendation The code should be structured so that on an involuntary conversion that causes a partnership to terminate, the partners would be able to separately elect to reinvest the proceeds from the involuntary conversion. This election should be available only where substantially all of the business assets of the partnership have been involuntarily converted. Partners not electing to reinvest would be taxed on these proceeds.

Discussion Currently, if a building used to carry on partnership business were destroyed by fire, the partnership would have to elect to reinvest these proceeds in similar property to avoid a gain from the involuntary conversion.[1] If some of the partners do not wish to continue the business, the remaining partners should be given the opportunity to take their share of the proceeds and reinvest them in a similar business under the provisions of sec. 1033. The partners not electing to reinvest would be subject to tax on their pro rata portion of the computed gain.

Lest this provision be used as a tax avoidance device whenever there is an involuntary conversion, certain constraints should be applied, such as limiting its application to situations where substantially all of the business assets of the partnership have been involuntarily converted.

4. Section 704(d) - Carryover of Excess Losses Where Partnership Is Terminated and New Partnership Is Formed.

Recommendation If a partnership is terminated under the rules of sec. 708(b)(1)(A) (the sale or exchange of 50 percent or more of the total interest in the partnership capital and profits within a twelve-month period) and a new partnership is formed, a partner in the predecessor partnership who enters the new partnership should be entitled to carry over any excess losses from the prior partnership. Carryovers should also be allowed where there has been a change in partners as a result of a nontaxable reorganization or liquidation of a subsidiary to which sec. 381 would apply.

Discussion The code contains certain instances where there could be an "involuntary" termination of a partnership. For example, if A owned a 60 percent interest in the capital and profits of ABC partnership and sold his interest to D, it would be considered that the ABC partnership terminated and a new partnership was formed. As a result, if partners B and C had had losses in excess of the tax bases of their partnership

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1. Mihran Demirjian, 54 T.C. 1691 (1970), aff'd 457 F.2d 1 (3d Cir. 1972); Roy P. Varner, et al., TC Memo 1973-27.

interests which could not be deducted under the limitations of sec. 704(d), these losses would not be available to them in the re-formed partnership. The purpose of this proposal is to allow these losses to be available where there has been a termination.

The task force recommends that carryover of excess losses also be available to a successor partner resulting from a nontaxable reorganization or liquidation of a subsidiary to which sec. 334(b)(1) applies. For example, if Corporation A is a 40 percent partner in the capital and profits of the ABC Partnership, and Corporation A is merged into Corporation D in a transaction qualifying under sec. 368(a)(1)(A), Corporation A's excess losses should carry over to Corporation D in the same manner as a net operating loss carries over under sec. 381. Similarly, in a situation where a subsidiary of a corporation is liquidated and sec. 334(b)(1) applies to the determination of basis, the excess losses of the subsidiary should carry over to the parent corporation. Thus, when the successor partner (the parent corporation) restores the tax basis to exceed zero, it should be entitled to deduct the losses previously disallowed to the subsidiary.

In the situation where the merged or liquidated corporate partner owned a 50 percent or greater interest in partnership profits and capital, see our recommendation 34.

5. <u>Section 706(b)(1) - Permit Automatic Adoption by New Partnership of a Fiscal Year Ending Within Three Months Prior to End of the Taxable Year of the Principal Partners</u>.

<u>Recommendation</u> A new partnership should be allowed to automatically adopt a fiscal year ending within three months prior to the end of the taxable year of the principal partners or within three months prior to the end of the calendar year, when all of the principal partners are not on the same fiscal year, without having to include the income for the short period and adjust for it over a ten-year period.

<u>Discussion</u> Rev. Proc. 72-51, 1972-2 CB 832, currently establishes procedures whereby a partnership may adopt a fiscal year ending within the three-month period described above. To obtain approval, the partnership must consent to report in its short period tax return the excess of its income over its expenses for the period following the short period to the end of what had been its previous fiscal year. In the case of a partnership switching from a calendar year to a

September 30 year end, this period would be three months. The partnership is then allowed to amortize this "doubling up" of income over a ten-year period.

The task force considers that this latter requirement should not be applicable in the case of a new partnership in that there is little likelihood of substantial distortion of income in the first year of the partnership. In addition, the adjustment under Rev. Proc. 72-51 is an administrative burden on the taxpayers; in some instances, inequitable results could occur when the adjustment may be deducted in future years by persons who were not members of the partnership when the income was required to be recognized.

The automatic selection of fiscal year by a new partnership would benefit the IRS in that it would be easy to administer and would cause many of the returns to be filed prior to April 15.

6. Section 706(c)(1)- Closing of Partnership Year as a Result of Death.

Recommendation The taxable year of a partnership should close with respect to a partner who dies unless his personal representative elects otherwise.

Discussion Present law provides that the taxable year of a partnership does not close with respect to a partner who dies, unless, as a result of such death, the partnership is terminated or a sale or exchange of the decedent's interest in the partnership occurs on the date of death. This provision prevents bunching of income in the final return of a decedent partner when, otherwise, two partnership years could close in such year. However, the inability to include such income in the decedent's final return often results in the loss of deductions and exemptions that could otherwise be offset against the decedent's share of partnership income to the date of death.

The present rule should be amended to provide that a partnership year with respect to a deceased partner shall close as of the date of the deceased partner's death, unless the deceased partner's personal representative or other person responsible for filing the decedent's final tax return elects to continue the partnership year for the decedent partner's interest.

The amendment of sec. 706(c)(2)(B) by the Tax Reform Act of 1976 reflected the intent of Congress to insure the propriety of allocations of income or loss where a partner enters or leaves a partnership during its taxable year. It is our view that the foregoing recommendation regarding the treatment resulting upon the death of a partner should be enacted as being in accord with such intent.

7. Section 707(c) - Guaranteed Payments Measured by Gross Receipts or Gross Income.

Recommendation Sec. 707(c) should be amended to include payments measured by a percentage of gross receipts or gross income within the definition of guaranteed payments.

Discussion Under sec. 707(c), a payment is not considered to be a guaranteed payment unless it is determined without regard to the income of the partnership. The Tax Court, in Pratt v. Comm., has held that management fees paid to partners based upon a percentage of gross rental receipts did not qualify as guaranteed payments because they were measured by the "income" of the partnership.[1] The Fifth Circuit Court of Appeals upheld the decision of the Tax Court in Pratt on the basis that the management fees were a distributive share of partnership income and not a deduction to the partnership under sec. 707(a), as contended by the petitioner. In so doing, the court did not have to question the deductibility of the management fee as a guaranteed payment under sec. 707(c). Had this section been amended as suggested above, the court could easily have disposed of the matter by holding the payments to be guaranteed payments and referring to their required inclusion in the income of the partner in the same year as the partnership deducted them by virtue of sec. 706(a).

Under the 1939 Internal Revenue Code, amounts paid to partners as salaries or interest were treated as distributions of partnership income. If the payments exceeded the partnership ordinary income, the excess was treated as a distribution out of the capital accounts of the partners. To the extent that the excess amount was charged to the capital account of the recipient partner, he was not taxed on that income; however, he

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1. Pratt v. Comm. 64 TC 203 (1975), aff'd 550 F.2d 1023 (5th Cir. 1977).

was taxed on the portion charged to the capital accounts of the other partners who, in turn, were entitled to a deduction for like amounts. The 1954 code adopted an entity approach and avoided the problem of the excess payment by treating such payments as expenses of the partnership. There appears to be no conceptual reason why payments for services of a fixed dollar amount should be treated as partnership expenses, whereas payments measured by a percentage of gross receipts or gross income should not be accorded the same treatment. If payments measured by a percentage of gross receipts or gross income are treated as distributive shares of partnership income rather than guaranteed payments, the unanswered question is how the amounts in excess of the ordinary income of the partnership would be treated. Presumably we would have to revert back to the case law under the 1939 code (as discussed above).

8. <u>Section 707(b)(2) - Sales of Land Used in Trade or Business Between Partners and Partnerships and Between Related Partnerships</u>.

<u>Recommendation</u> The statute presently provides that gains from the sale or exchange of property between a partnership and a partner having a requisite percentage of interest in the partnership, or between certain related partnerships, is treated as ordinary income if the property is other than a capital asset in the hands of the transferee. The statute should be amended to provide for such ordinary income treatment only when the property in the hands of the transferee is property subject to allowance for depreciation.

<u>Discussion</u> The proposed amendment would conform sec. 707(b)(2) to sec. 1239(a)(2), dealing with sales or exchanges of property between a corporation and a controlling shareholder. Sec. 707(b)(2) is much broader than sec. 1239; it would convert gain on sales of land used in a partner's trade or business to a "controlled partnership" from sec. 1231 gain to ordinary income. Even if the land in the hands of the selling partner (or partnership) were a capital asset, ordinary income treatment would result if the land were used in the transferee's trade or business. There appears to be no policy reason to apply harsher treatment to dealings between partners and partnerships than is applied to relationships between corporations and stockholders. Language in the senate committee report

indicates that it was the intention of Congress to conform the partnership rules to the corporation rules. The committee report provided, in part, that "Subsection (b) . . . is designed to prevent tax avoidance through the realization of fictitious losses or increasing the basis of property for purposes of depreciation" [Emphasis added]. It further stated that "The provisions of the House bill, however, have been amended by your committee by adopting the rules comparable to those which are applicable in the case of sales of property between corporations and controlling shareholders under sections 267 and 1240." Inasmuch as sec. 1240 is completely irrelevant to the matter, the reference to sec. 1240 apparently was intended to mean sec. 1239.[1]

9. Section 707(b)(1)(B)/Section 707(b)(2)(B) - Definition of Common Ownership.

Recommendation The statute should be amended to provide that two partnerships will not be deemed to be "controlled partnerships" (for purposes of loss disallowance and conversion of capital gain to ordinary income) unless more than 50 percent of the capital interests or profits interests are owned by the same persons, taking into account the ownership interests of such persons only to the extent that such ownership interests are identical with respect to each partnership.

Discussion This change would conform the definition of controlled partnerships to that of controlled corporations as provided in sec. 1563 and sec. 1551. The aggregate 80 percent common ownership requirement in sec. 707(b)(2)(B) would be retained.

The present statute could result in disallowance of losses or conversion of capital gain to ordinary income on sales between partnerships when there is only a small amount of common ownership. For example, if the AB partnership is owned 95 percent by partner A and 5 percent by partner B and the BA partnership is owned 95 percent by partner B and 5 percent by partner A, transactions between these partnerships would be subject to the proscriptions of sec. 707(b), even though taking into account only the identical interests of each partner in the two partnerships, the common

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1. U.S., Congress, Senate, 83d Cong., 2d Sess., S.Rep. No. 1622, 1954, p. 386.

ownership interests amount to only 10 percent.

The provision could be structured to exclude consideration of transfers made to avoid the percentage tests within a specified time period preceding the transactions.

10. Section 709(b) - Amortization of Organizational and Reorganizational Expenditures.

Recommendation Organizational and reorganizational expenditures should be amortizable unless partnerships elect to capitalize.

Discussion Section 709(b) provides that organizational expenses may, at the election of a partnership, be amortized over a period of not less than sixty months. This election must be made in the return for the taxable year in which the partnership begins business, and all of the expenditures subject to the election must be specifically identified.

The rule should be that organizational expenses are amortizable unless an election is made not to amortize. This rule should be applicable to reorganizational expenditures as well as organizational expenditures of both corporations and partnerships. They should be treated uniformly.

11. Section 732(d) - Sales of Partnership Interests.

Recommendation The relief provision of sec. 732(d), permitting a transferee partner to step up the basis of inventory items and unrealized receivables distributed to him from the partnership when the distribution is made within two years of the date of his acquisition of the partnership interest, should be extended to sales or exchanges of the partnership interests within the two-year period (See also recommendation 14).

Discussion A partner who purchases an interest in a partnership that owns inventory items or unrealized receivables and does not have an election under sec. 754 in effect will realize ordinary income to the extent of his distributive share of partnership income realized from the disposition of such inventory items or unrealized receivables notwithstanding the fact that a portion of his purchase price was allocable to those items. A partner can avoid this unfair result by making an election under sec. 732(d) if he receives a distribution of such assets within a period of two years from the time he purchased his partnership interest. No such relief is available with respect to a sale of his partnership interest.

Suppose, for example, that C purchases for $4,000 a one-third interest in the AB partnership. The sale asset of the partnership is an unrealized receivable in the face amount of $12,000 having a zero tax basis, and the partnership has no liabilities. Before anything else has occurred, C resells his partnership interest for $4,000. The anomalous result under the present law is that C would realize ordinary income of $4,000 upon the sale and would have a capital loss of $4,000. The proposed amendment would afford partial relief against such inequity.

12. <u>Section 732(d) - Time for Making Election</u>.

<u>Recommendation</u> The statute should be amended to provide that the election provided under sec. 732(d) may be made at any time prior to the expiration of the statute of limitations for the taxable year in which the distribution or sale giving rise to the election occurred. (See recommendation 11).

<u>Discussion</u> Regs. sec. 1.732-1(d)(2) provides that the sec. 732(d) election shall be made with the transferee partner's tax return for the year of the distribution if the distribution includes any depreciable or depletable property; otherwise, it may be made no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax. The election under sec. 732(d) is easily overlooked, especially if the taxpayer is without competent professional advice in the year of distribution. The failure to make a sec. 732(d) election may have very serious consequences, particularly if solely unrealized receivables or inventory items are distributed--in which case, the excess of the partner's basis of his partnership interest over the carryover partnership basis in the unrealized receivables or inventory items becomes a capital loss in the year of distribution. To avoid what has become a trap for the unwary, we have made the foregoing recommendation concerning the time for making the election. The task force believes that such a change would not result in any significant tax avoidance opportunities. Furthermore, it provides a time certain for making the election. Under normal circumstances, the time

period for making the election would be three years from the year of the transfer which causes sec. 732(d) to be applicable. Under the present regulations, a question could arise about when the basis of distributed property is pertinent in determining the taxpayer's income tax. For example, if some of the distributed property were sold in a given taxable year in which the taxpayer had a net operating loss, would the basis of the distributed property be considered pertinent in determining his income tax for that year? See our similar recommendation concerning the time for making an election under sec. 754, (recommendation no. 21).

13. <u>Section 736(a) - Carryover of Deductions to Successor Entity</u>.

<u>Recommendation</u> Sec. 736 should be amended to provide that where payments (other than those described in sec. 736(b)) are being made in liquidation of the interest of a retiring partner or a deceased partner and such payments are assumed by a transferee of the partnership in a tax-free transfer, the transferee shall be entitled to deduct such payments.

<u>Discussion</u> In Rev. Rul. 75-154, the IRS held that periodic payments made after termination of a partnership in satisfaction of a partnership liability to a previously retired partner under sec. 736 are deductible as business expenses. If the partners transferred their interests in the partnership to a corporation by means of a transaction that qualified under sec. 351, which continued to make payments to a retiring partner under sec. 736(a), it follows that these payments should be deductible by the corporation. Under present law, the payments would appear not to be deductible, since they would not be regarded as having been made by a partnership, nor would they be ordinary and necessary expenses to the corporation under sec. 162.

14. <u>Section 741 - Recognition and Character of Gain or Loss on Sale or Exchange</u>.

<u>Recommendation</u> Sec. 741 should be amended to provide that

(1) gain or loss recognized on the sale or exchange of a partnership interest shall be capital gain or loss and that ordinary income to be realized on such a sale or exchange is the lesser of the actual gain or the partner's interest in potential sec. 751 gain.

(2) any gain to be realized as a result of the application of sec. 731(a) shall be taxed as ordinary income to the extent of the partner's "potential sec. 751 gain" reduced by any amounts previously reported as ordinary income attributable to application of sec. 731(a).

Discussion Under present rules, a transferor of a partnership interest by sale or exchange recognizes capital gain or loss measured by the difference between the amount realized and the transferor's adjusted basis of his partnership interest. However, the amount realized from the sale or exchange of the partnership interest does not include any portion of the consideration received attributable to the partner's interest in sec. 751 partnership property (regs. sec. 1.741-1(a)). The net result of these rules is that the partner is deemed to have made two sales, namely, a sale of his partnership interest and a separate sale of his interest in sec. 751 property. Any basis the selling partner has in the unrealized receivable is transferred from his basis in the partnership interest to basis of the sec. 751 property sold.

The net effect of the above rules is that a selling partner may have to realize ordinary income in excess of his economic gain on the sale of the partnership interest. The difference is represented by a capital loss. Furthermore, the rule applies even if the partner has an economic loss on the transaction. Any ordinary income realized from the sale of the sec. 751 property increases the capital loss realized.

The foregoing rule has been criticized primarily for (1) complexities in determining whether there is any sec. 751 property and (2) the basic unfairness of requiring the reporting of ordinary income in excess of economic income realized on the sale coupled with the limitations on the amount of capital losses that a taxpayer may report. The task force believes that simplification could be introduced into the code if the present definition of sec. 751 property were changed as suggested by recommendation 15. In substance, that recommendation is that a new concept of "potential sec. 751 gain" be introduced into the code in lieu of the present definition of sec. 751 property. Each partner would be deemed to have an interest in "potential sec. 751 gain."

The task force's recommendation is that ordinary income recognized on the sale or exchange of a partnership interest be limited to the lesser of (1) the actual gain realized by the partner or (2) the partner's interest in "potential sec. 751 gain" of the partnership attributable to the partnership interest sold. This would be similar to the depreciation recapture rules under sec. 1245. The task force's recommendation can be implemented by eliminating the current requirement of separating the consideration received for the sale of the partnership interest into two separate sales prices, namely a sales price attributable to the partnership interest (capital asset) and a sales price attributable to sec. 751 property (noncapital asset).

A reduction of a partner's share of liabilities is deemed to be money distributed to the partner pursuant to sec. 752(b). Sec. 731(a)(1) provides that gain is to be recognized to the extent such distribution of money exceeds the partner's adjusted basis of his partnership interest. Such gain is characterized as gain from sale of the partnership interest of such distributee partner. The task force has recommended that ordinary income be realized on the sale of a partner's interest in a partnership to the extent of a partner's "potential sec. 751 gain"; however, since gain required to be reported under sec. 731(a) can occur in more than one year and since the partner still has his interest in the partnership, the amount of "potential sec. 751 gain" applicable to that partner should be reduced by amounts of "potential sec. 751 gain" previously reported.

See also recommendation 11 regarding sales or exchanges of partnership interests within two years from acquisition with regard to the application of sec. 732(d). However, should this recommendation be accepted, recommendation 11 would be obviated.

15. Section 751 - Unrealized Receivables and Inventory Items Which Have Appreciated Substantially in Value.

Recommendation The definition of unrealized receivables and inventory items should be eliminated from the code and, in lieu thereof, a concept of "potential sec. 751 gain" should be enacted. Potential sec. 751 gain of a partnership would be defined as the net amount of ordinary income the partnership would have to report if it sold all its assets at fair market value.

Discussion The present rules defining sec. 751 property are complex, confusing, and appear to have no consistent rationale. The basic purpose of sec. 751 (especially as used in connection with sec. 741) is to prevent a seller of a partnership interest from converting his share of potential ordinary income to capital gain. Because this is similar to the rationale of sec. 341 relating to collapsible corporations, sec. 751 is referred to as the "collapsible partnership section."

The stated purpose is not, in fact, achieved. Sec. 751(a)(1) provides for absolute recognition of ordinary income attributable to unrealized receivables. Sec. 751(c) provides that unrealized receivables include not only receivables but also, among others, depreciation recapture potential under sec. 1245(a) or sec. 1250(a). The inclusion of depreciation recapture potential in the term "unrealized receivables" creates problems for taxpayers.

Sec. 751(a)(2) provides for the recognition of gain attributable to appreciated inventory only if the inventory has appreciated substantially. Sec. 751(d) provides that inventory items are considered to have appreciated substantially if their fair market value exceeds (1) 120 percent of their adjusted basis to the partnership and (2) 10 percent of the fair market value of all partnership property excluding cash. Here again, the term "appreciated inventory" has a different meaning than taxpayers would normally attribute to the term "inventory." Inventory items include not only traditional inventory items as defined in sec. 1221(1) but also any partnership property that is not a capital asset or sec. 1231 property. Inventory items also include items of partnership property which, if held by the selling or distributee partner, would be considered the type of property included in the definition of inventory items. The effect of this is to change the character of the property in the hands of the partnership to the character of the property were it held by the partner.

It should be noted that, under the present rules, a seller of a partnership interest could realize ordinary income for his interest in unrealized receivables, while no recognition is given for ordinary losses not yet recognized attributable to depreciated inventory or sec. 1231 property.

Under the task force's recommendation, all unrealized ordinary income and losses (including net sec. 1231 losses) would be netted. If there is a net gain, it would be classified as "potential sec. 751 gain" of the partnership. Each partner will be deemed to have his share of the "potential sec. 751 gain" similar to the present rules determining his share of sec. 751 property.

The following illustrates the principles set forth in this recommendation as well as recommendation 14.

Balance Sheet of AB Partnership

	Partnership basis	Fair market value	Potential Sec. 751 gain	Sec. 1231 gains and losses
Assets				
Cash	10,000	10,000		
Accounts receivable	30,000	35,000	5,000	
Inventory	60,000	75,000	15,000	
Land	30,000	50,000		20,000
Building	100,000	60,000		(40,000)
Equipment	70,000	80,000	10,000	
Capital stock, X Corp.	30,000	60,000		
Previously expensed items	-0-	5,000	5,000	
Total	330,000	375,000	35,000	(20,000)
Liabilities and Capital				
Liabilities	150,000	150,000		
Capital				
A (2/3)	120,000	150,000		
B (1/3)	60,000	75,000		
Total	330,000	375,000		
Offset sec. 1231 loss (net)			(20,000)	20,000
Potential sec. 751 gain			15,000	-0-

A's share of potential sec. 751 gain would be $10,000 and B's share would be $5,000. If B were to sell his interest for $75,000, and the tax basis of his interest was $60,000, B would realize ordinary income of $5,000 and a capital gain of $10,000 (see recommendation 14). On the other hand, if B's adjusted partnership interest tax basis was $72,000, B would realize a gain of $3,000 on the sale and the entire $3,000 would be ordinary income.

16. Section 736(b)(2)(A) - Payments to a Retiring Partner or a Deceased Partner's Successor-in-Interest.

Recommendation Sec. 736(b)(2)(A) should be amended to provide that payments in exchange for an interest in partnership property will not be considered sec. 736(b)(2) payments to the extent of the lesser of the partner's interest in potential sec. 751 gain or the amount of actual gain such partner would have realized if he had sold or exchanged such interest.

Discussion The task force recommends that sec. 741 be amended to provide that ordinary income recognized on the sale or exchange of a partnership interest be the lesser of the actual gain realized or the "potential sec. 751 gain" on the sale. The task force is also recommending changes in the definition of sec. 751 property, the essence of which is to simplify the calculation of "potential sec. 751 gain" and to determine ordinary income on the sale or exchange of a partnership interest by reference to such "potential sec. 751 gain" similar to depreciation recapture rules under sec. 1245 (see recommendations numbers 14 and 15).

Under present rules, sec. 736(b)(2)(A) treats payments made in liquidation of retiring partners' or deceased partners' interest in a portion of sec. 751 property (namely unrealized receivables) in excess of their partnership basis as payments under sec. 736(a). The effect of this is to tax as ordinary income the payments received for the partner's interest in such property similar to the amount of ordinary income the partner would have reported if he had sold or exchanged his interest.

So that a retiring or deceased partner's successor-in-interest need not report more ordinary income on liquidation of his interest in partnership property than if he had sold the interest (pursuant to the task force's recommendations relating to sec. 741 and sec. 751), it is necessary to amend sec. 736(b)(2)(A) to provide that payments in exchange for an interest in partnership property shall not include amounts paid for the partner's interest in potential sec. 751 gain property (as redefined) to the extent of the lesser of the partner's interest in such potential sec. 751 gain property or the actual gain the partner would have realized if he had sold his partnership interest at fair market value. The amounts so excluded would be treated as sec. 736(a) payments.

The present rules regarding inclusion of partnership goodwill in payments for partnership property should continue.

17. <u>Section 743 - Addition of Gift Tax to Basis</u>.

<u>Recommendation</u> Sec. 743(b) should be amended to include a transfer by gift as a qualifying transfer for purposes of applying the sec. 743(b) adjustment.

<u>Discussion</u> The optional adjustment to basis of partnership property pursuant to an election under sec. 754 is designed to reflect basis in partnership assets on transfer of a partnership interest when the transferor's basis does not carry over to the transferee, such as the transfer of a partnership interest by sale or exchange or on death under sec. 743(b). Although transfer of a partnership interest by gift involves carryover of the donor's basis, the adjustment to basis in the hands of the transferee as a result of the gift tax paid can be substantial. Accordingly, it is recommended that transfer of a partnership interest by gift be covered by the sec. 754 election, subject to an exclusion for de minimus gift taxes, in order to enable such additional basis to be reflected in partnership assets on behalf of the transferee.

18. <u>Section 751(b) - Exempt Admission of a Partner or Change in Partner's Interest From Sale or Exchange Rules</u>.

<u>Recommendation</u> The admission of a new partner to an existing partnership or the increase of an existing partner's percentage interest in a partnership should not be considered as a sale of, or exchange of, the existing partners' interests and should therefore not cause the existing partners to recognize gain as a result of a reduction in their share of liabilities.

Discussion Sec. 751(b), as presently constituted, appears to apply literally every time a partner's interest in a partnership is reduced either by the admission of a new partner or the increase of another partner's interest in the partnership, even though the partner whose interest was reduced in fact received nothing from the partnership. The reduction of the partner's interest in the partnership results in his having a reduced interest in the partnership assets (including "sec. 751 gain" property) as well as a reduced share of partnership liabilities. Under sec. 752(b), this reduction of share of liabilities is deemed a distribution of money to the partner whose interest was reduced.

Regs. sec. 1.751-1(g), example 2, makes it clear that a reduction of a partner's share of liabilities pursuant to sec. 752(b) is money distributed to a partner for purposes of sec. 751(b). Since such distribution occurred in connection with the partner's giving up his interest in partnership property, sec. 751(b) would appear to be applicable. The code and/or regulations should be amended to provide that, where a partner's interest is reduced in a partnership as a result of the admission of partners or the increase of other partners' interest, the money deemed distributed to the partner as a result of application of sec. 752 shall not be deemed to have been received by that partner in exchange for his interest in sec. 751 property.

19. Section 751(c) - Unrealized Receivables, and Section 751(d) Inventory Items That Have Appreciated Substantially in Value.

Recommendation

1. Sec. 751(c) and (d) should be eliminated from the code.

2. A new sec. 751(c) should be enacted to define "potential sec. 751 gain."

3. Sec. 732 should be amended to provide for definitions of unrealized receivables and inventory items, as presently contained in sec. 751(c) and (d).

Discussion The task force recommends the substitution of "potential sec. 751 gain" as the measure of potential maximum ordinary income to be realized on the sale or exchange of partnership interests. See recommendations 11, 14, and 15. The definition of "potential sec. 751 gain" is set forth in recommendation 15.

Sec. 732(c) provides for the allocation of basis to properties received by a partner as a distribution from a partnership. In order to prevent potential abuses, sec. 732(c)(1) provides for allocation of basis first to unrealized receivables as defined in sec. 751(c) and inventory items as defined in sec. 751(d). In order to continue to prevent abuse potentials, sec. 732(c) should be amended to eliminate the references to sec. 751(c) and (d). The definitions of unrealized receivables and inventory should be incorporated in sec. 732.

SUBSTANTIVE CHANGES IN THE TREASURY REGULATIONS

20. Section 732(d) - Automatic Election Upon a Section 708 Termination.

21. Section 754 - Extend Period for Making Election.

22. Section 755 - Rules for Allocation of Basis Regulations Section 1.755-1.

20. Section 732(d) - Automatic Election Upon a Section 708 Termination.

Recommendation A partner receiving a constructive distribution of partnership property pursuant to regs. sec. 1.708-1(b)(1)(iv) will be deemed to have made a sec. 732(d) election unless he elects to the contrary by the due date for the new partnership's first return.

Discussion A partnership terminates if 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a twelve-month period. Under regs. sec. 1.708-1(b)(1)(iv), upon such a termination the partnership is deemed to have distributed its properties to the purchaser and the remaining partners in proportion to their respective interests in the partnership properties, and immediately thereafter the purchaser and the remaining partners are deemed to have recontributed the properties to a new partnership. Usually, there will be no gain or loss upon the constructive distribution and, through the operation of sec. 732 and sec. 722, the basis of the properties deemed contributed to the new partnership by the purchasing partner will be equal to the purchase price of the partnership interest. However, if the only assets owned by the partnership were unrealized receivables and inventory items, in the absence of a sec. 732(d) election by the distributee partner or a sec. 754 election by the old partnership, the properties retain a carryover basis from the old partnership and the excess of the transferee's basis in his partnership interest over the partnership basis of properties deemed distributed to him becomes a capital loss. See regs. sec. 1.732-1(c)(2). The adjustment to basis would be automatic unless the purchasing partner affirmatively elects not to have this provision apply. This election would be filed with the first tax return for the new partnership.

21. Section 754 - Extend Period for Making Election.

Recommendation The period of time for making the election under sec. 754 should be extended to the expiration of the statute of limitations for the taxable year in which the event giving rise to the election occurs. (Also see recommendation 32.)

Discussion The present regulations require that the election be made by the filing date of the income tax return (including extensions) for the first taxable year to which this election applies. This time period is too short and may cause taxpayers who are unaware of the benefits to fail to file a timely election.

Additionally, the death of a partner is a frequent reason for filing the election. Inasmuch as the estate tax return may not be filed by the time the return is due, the decedent's estate or other successor would not be able to evaluate the effect of the election by the due date of the partnership return. The other partner may insist that the partnership return be filed by the due date and thus not provide the decedent's estate adequate time to determine if an election should be filed.

In Allison v. U.S., the Court stated:

> The time limitation imposed in Commissioner's regulation 1.754-1 is patently unreasonable, at least with respect to cases involving the transfer of a partnership interest due to the death of a partner, in that in many instances the value of the partnership interest is not finally determined, as here, in the same year the transfer due to death occurred. Until the value of the partnership interest is finally determined, an intelligent decision whether to elect under Section 754 is impossible. In the instant case, plaintiff filed his Section 754 election shortly after the federal estate tax settlement of the deceased partner, incorporated in the order of the Tax Court, which had the effect of greatly increasing the basis of plaintiff's partnership interest. To require a partnership to file a Section 754 election before the basis of a transferred interest has been finally determined simply is not rational. Congress imposed no time limitation in the statute with respect to making an election under Section 754, and although a more narrowly drawn regulation with respect to the timing of an election might be valid, one that proscribes an election under the facts of this case and similar cases involving transfers of partnership interests due to the death of partners is untenable and void. Since the regulation goes

a long way toward negating the relief which Congress intended should be available to a transferee partner, the regulation is a nullity.[1]

In recommendation 12, we discussed various reasons why the time for making the election under sec. 732(d) should be extended to the time prior to the expiration of the statute of limitations. The reasons stated in that discussion are similarly applicable here and are offered here by reference to that recommendation.

22. Section 755 - Rules for Allocation of Basis Regulations Section 1.755-1.

Recommendations

Section 755(b) should be amended as follows:

1. Eliminate the categorization of assets as (a) capital assets and property described in sec. 1231 or (b) all other property of the partnership.

2. Provide that, where an adjustment is made pursuant to a transfer of an interest under sec. 743(b), the adjustment be made on the difference between tax basis and fair market value of all assets.

3. Provide that, where an adjustment is made pursuant to a distribution under sec. 734(b), the adjustment be made to similar property; however, if the full adjustment cannot be made because of the absence of property, the adjustment be made to other property pursuant to regulations.

Discussion In the case of a transfer of an interest (especially by sale), the net adjustment to be made is generally the difference between the fair market value of the transferor's interest in each asset of the partnership and the transferor's share of the common partnership basis. Accordingly, if the special basis adjustment is made to all assets by recognizing both increases and decreases, the tax basis of each asset to that partner (common partnership basis increased or decreased by the special basis adjustment) will equal the fair market value that the partner actually

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1. Allison v. U.S., 379 F.Supp. 490 (D.C. Pa. 1974).

paid for his interest in the partnership assets. This is preferable to the present rules.

The task force believes it is proper to adjust the tax basis of similar property to that property which is being distributed and causing an adjustment to be made under sec. 734(b). However, if similar property is not available, or there is no remaining basis to be adjusted, the adjustment should be made to other property rather than holding the adjustment in suspense.

The task force does not believe these proposals will result in abuses.

TECHNICAL CHANGES IN THE INTERNAL REVENUE CODE INCLUDING RECOMMENDATIONS FOR CLARIFICATION

23. Section 702(c) - Partner's Share of Gross Receipts.

24. Section 704(e)(3) - Sale of Interest in Partnership by One Family Member to Another Should not Be Considered Gift Where Sold for Adequate Consideration.

25. Section 707 - Timing for Taxation of Income for a Guaranteed Payment for Services of a Capital Nature.

26. Section 709 - Deductibility of Syndication Fees.

27. Section 721 - Transfer of Capital Interests for Services.

28. Section 736 - Separate Definition of Guaranteed Payments From Section 707(c).

29. Section 736 - Define Meaning of "Payment."

30. Section 736(b) - Timing of Step-Up in Basis Under Section 734.

31. Section 741 - Recognition of Limited Gain on Distribution of Partnership in Corporate Liquidation.

32. Section 754 - Provide Separate Elections of the Provisions of Section 734 and Section 743.

23. Section 702(c) - Partner's Share of Gross Receipts.

Recommendation Sec. 702(c) should be amended by adding the words "or gross receipts" after "gross income" in both places where the phrase appears in the subsection.

Discussion The election of a subchapter S corporation will terminate for any taxable year in which more than 20 percent of its gross receipts is "passive investment income." In the case of a corporation having filed a subchapter S election, it is necessary to determine to what extent it should include in gross receipts the gross receipts of a partnership in which it is the partner. The IRS has ruled that an electing small business corporation must include its distributive share of partnership gross receipts for the purpose of applying the 20 percent passive investment income test. See Rev. Rul. 71-455, 1971-2 CB 318.

It is also necessary for a company engaged in the business of farming to compute its gross receipts for determining whether it must use the accrual basis of accounting. See sec. 447.

Although the question has been resolved administratively, we believe that it would be preferable for the statute to be amended to clarify the treatment of partnership gross receipts.

24. Section 704(e)(3) - Sale of Interest in Partnership by One Family Member to Another Should not Be Considered Gift When Sold for Adequate Consideration.

Recommendation This section provides that an interest purchased by one member of a family from another shall be considered to be created by gift from the seller. In cases where the interest is sold for adequate consideration, there is no reason why it should be considered as created by gift. This provision should be modified to conform to regs. sec. 1.704-1(e)(4), in that a purchase of a capital interest in a partnership will be recognized as bona fide if it can be shown that the purchase has the usual characteristics of an arm's-length transaction or that the purchase was genuinely intended to promote the success of the business.

Discussion Notwithstanding the statutory language of sec. 704(e)(3), the regulations clarify that the family partnership allocation rules will be applied only in cases in which the transfer or creation of a partnership interest has any of the substantial characteristics of a gift, but will not be applied where there is a bona fide arm's-length purchase. Inasmuch as the regulations reach a logical and equitable result, the statute should be amended to conform, or relate to, the regulations.

25. Section 707 - Timing of Taxation of Income for a Guaranteed Payment for Services of a Capital Nature.

Recommendation Partners who receive guaranteed payments that are for services of a capital nature should be required to include such payments in income as of the close of the partnership year in which they were paid.

Discussion The Tax Reform Act of 1976 requires the capitalization of guaranteed payments under sec. 707(c) that are for services representing capital expenses. Technically, however, the service partner is not taxed on this income until the partnership is entitled to a deduction for the capitalized amount. Sec. 706(a) provides that the partner who receives a guaranteed payment must include it in his income based on the deduction of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner. The partnership may deduct the capitalized payments only through a series of depreciation deductions, upon sale of the property, or, perhaps, never (for example, if the payments were for syndication fees). Therefore, the language of sec. 706(a), literally taken, could result in an indefinite deferral of the income by the partner receiving the payment.

This result may be avoided by requiring guaranteed payments for services rendered which are capital expenditures to be taxable to the recipient partner as of the close of the partnership year in which the payments are made.

26. Section 709 - Deductibility of Syndication Fees.

Recommendation Clarify the code so that the amount of syndication fees that are not deducted or allowed to be deducted pursuant to sec. 709(a)

1. will not reduce a partner's tax basis or his interest in the partnership, and

2. a partner who pays or incurs such expenses will be entitled to a deduction to the extent that payments are made from funds that were (a) received by that partner from the partnership, (b) treated by the partnership as syndication expenses under sec. 709(a), and (c) required to be reported as income by the recipient partner.

Discussion The language of sec. 709 regarding expenditures for syndication is so restrictive that, if interpreted technically, no deduction may ever be claimed for these expenses. This treatment is harsher than that imposed on corporations inasmuch as these expenses will eventually be deducted by the original purchaser of stock of a corporation when he disposes of his stock. In a partnership, it is ambiguous whether the partnership would have to treat these expenses either as a nondeductible amount reducing the partners' capital account and tax basis in the partnership or as a capitalized expense that may never be deductible. The task force believes that Congress did not intend to treat these expenditures in a harsh or complex manner, but to equate them to the corporate tax treatment of costs of a partner's interest.

The General Explanation of the Tax Reform Act of 1976 prepared by the staff of the Joint Committee on Taxation, in its discussion of the amortization of organization costs and the treatment of syndication fees, refers to these syndication fees as capitalized syndication fees, thus indicating that Congress intended these expenses to be capitalized on the books rather than charged against the partners' capital account.

In the event of a liquidation of a partnership, these expenses should not reduce the partner's tax bases or, in the event the circumstances described under sec. 731(a)(2) exist, should be allowed as a capital loss.

If a partner, who is also the promoter or underwriter of the partnership, pays others a commission or other payment for selling partnership interests and makes such payments as a promoter and not as a partner, he should be entitled to an ordinary deduction for these payments. A literal interpretation of sec. 709 precludes this treatment inasmuch as it prohibits a deduction to "any partner" for amounts paid or incurred to promote the sale of, or to sell, an interest. To the extent the partnership reimburses the promoter or underwriter, these amounts should be treated as discussed above.

27. Section 721 - Transfer of Capital Interests for Services.

Recommendation

1. The transfer of a capital interest to a partner in exchange for services rendered would be governed by the provisions of sec. 83. Thus, if the transfer of a capital interest was not subject to a substantial risk of forfeiture, the transferee partner would realize ordinary income in the year of transfer to the extent of fair market value of the capital interest transferred. There would be a corresponding deduction available to the partnership.

   Rules peculiar to partnerships would have to be adopted. For example, the deduction available to the partnership would be allocated to the partners who relinquished capital interests in proportion to the amount of capital interests relinquished. The excess of the fair market value of the interest relinquished over its tax basis would be taxable gain to the partner relinquishing the interest. The partner receiving the capital interest would be entitled to a special basis adjustment to partnership property (similar to a sec. 743(b) adjustment) equal to the amount of gain realized by the other partners.

2. The application of sec. 83 to such transactions would be modified by providing that unrealized income items would be excluded from the definition of "property." Thus, the value of the capital interest transferred to the service partner would be reduced by the amount of the unrealized income items. Unrealized income items are defined as the excess of the fair market value over the tax basis of assets that would produce ordinary income upon disposition.

3. Transfer of a future interest in net profits is not a transfer of property.

Discussion The purpose of these recommendations is to clarify the tax treatment of transfers of capital interests to partners performing services for a partnership. They would also make clear that the receipt of an interest in future profits of the partnership would not be a taxable event and thereby eliminate the confusion engendered by the decision in Sol Diamond.[1] Generally, the treatment of a transfer of a capital interest for services is adequately covered by sec. 83. The application of sec. 83 to partnerships, such as the manner of allocating the deduction among partners and the special basis adjustment to the service partner, discussed above, could be covered in regulations.

The modification relating to "unrealized income items" was proposed in order to avoid double taxation of the service partner. Without the adjustment, the service partner would realize ordinary income upon receipt of the capital interest and then again when the income was realized by the partnership. An alternative means of coping with this problem would be to allow the service partner a special basis adjustment with respect to the unrealized income items. We rejected the latter approach because it would be burdensome and would inject additional complexity into the code. We believe that the suggested approach would not encourage tax avoidance, because the unrealized income items would be realized by the partnership in the ordinary course of business, at which time the service partner would recognize his share of the income.

As required by the proposed regulations under sec. 83, if the services rendered were of a capital nature, the value of the capital interest transferred to the service partner would be capitalized to the applicable asset or assets. How this would work may best be illustrated by the following example. A, B, and C are equal partners in the ABC partnership. The sole asset of the partnership is land with a tax basis of $3,000 and a fair market value of $4,000. There are no partnership liabilities. A, B, and C each agreed to transfer one-fourth of their capital interests to D in exchange for his services in constructing improvements on the partnership land. Thus, D is admitted as a one-fourth partner and the following journal entry is made on the partnership books, which are maintained on a tax

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1. Sol Diamond, 492 F.2d 286 (7th Cir., 1974).

basis: Debit the capital accounts of A, B, and C in the amount of $250 each; credit the capital account of D in the amount of $750. The tax consequences of the transaction would be as follows:

1. D realizes ordinary income in the amount of $1,000 (one-fourth of the $4,000 partnership capital at fair market value).

2. The amount of $1,000 is capitalized to improvements on land. The cost of these improvements are specially allocated so that partners A, B, and C each have a basis increase of $333 in the property and their respective shares of the partnership basis in the land have been reduced by $250 each as a result of the transfer to D.

3. Partners A, B, and C each recognize $83 gain on the constructive sale of one-fourth of each of their interests in the partnership property (the unrealized appreciation on the land allocable to each of the three original partners is $333; one-fourth of this unrealized appreciation is $83).

4. D is entitled to a special basis adjustment with respect to the partnership land in the amount of the gain recognized by partners A, B, and C (aggregating $250). Thus, D's share of the basis of partnership property would be $1,000, composed of his share of the common basis of partnership land of $750 and his special basis adjustment of $250 (see step 2).

5. The basis of D's interest in the partnership would be $1,000.

6. The basis of A's, B's, and C's interests in the partnership would be $1,083. Each would be reduced $250 because of transfer of basis to D, but increased $333 because of the deemed contribution of improvements.

   To account for these special basis adjustments on the books of the partnership is complex and imposes a greater burden on the partnership. In recommendation 39, we suggest that all special basis adjustments be made on the books of the partners and not on those of the partnership. Likewise, these special basis adjustments should be recorded only by the partners.

28. Section 736 - Separate Definition of Guaranteed Payments From Section 707(c).

Recommendation Sec. 736(a)(2) should not refer to treatment as a "guaranteed payment described in sec. 707(c)" but rather should read "as an ordinary and necessary expense if the amount thereof is determined without regard to the income of the partnership."

Discussion There has been considerable confusion and uncertainty about what constitutes a "guaranteed payment described in sec. 707(c)." See Pratt v. Comm.[1] and recommendation 7. The Tax Reform Act of 1976 clarified sec. 707(c) so that guaranteed payments that are capital in nature are required to be capitalized. The House Ways and Means Committee specifically recognized that this provision should not apply to sec. 736(a)(2) payments that are considered as guaranteed payments. However, it failed to recommend codification of this provision.

The task force considers that the treatment of these payments may better be described as set forth above. A conforming change should be made to sec. 706(a), that is, sec. 736(a)(2) should be added to it.

29. Section 736 - Define Meaning of "Payment."

Recommendation Sec. 736 should be amended to make clear that the term "payments made in liquidation of the interest of a retiring partner or a deceased partner" under sec. 736(a) shall include actual payments made during the fiscal year of the partnership and amounts credited to the account of the retiring or deceased partner in excess of his share of the income distributed for that year.

Discussion Sec. 736(a) provides for payments made in liquidation of the interest of a retiring or deceased partner to be considered as a distributive share of the partnership income if the amount is determined with regard to partnership income or as a guaranteed payment described in sec. 707(c) if the amount is otherwise determined (see recommendation 28).

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1. Pratt v. Comm., 64 T.C. 203, aff'd 550 F.2d 1023 (5th Cir., 1977).

Regarding partnerships that report on the cash basis, it is uncertain whether these "payments" would actually have to be made prior to the end of the year to be deducted by the partnership that year. If they were required to be paid, this could be an impossible situation where the amount is based on a distributive share of partnership income. For example, assume A is to receive 10 percent of the partnership income for 1975 as a sec. 736(a) payment. During the year, A is paid $20,000, and the partnership actually earns $250,000. A is due an additional $5,000, which is credited to his account by the partnership for its year ending December 31, 1975, and is paid to him by the partnership on April 15, 1976. As a cash basis taxpayer, the partnership cannot deduct the remaining $5,000 even though it was a payment to A for 1975. This situation not only creates problems for A, but for each member of that partnership.

To remedy this area of concern, the task force suggests that the code be amended to clarify payment to include any payments made during the fiscal year of the partnership for distributions relating to that fiscal year and any such amounts properly credited to the account of the retiring or deceased partner for his share of the partnership income for that year in excess of those amounts already distributed to him.

30. Section 736(b) - Timing of Step-Up in Basis Under Section 734.

Recommendation The step-up in basis as provided under sec. 734 should be made at the time the agreement is consummated to liquidate a partner's interest irrespective of the time when actual payments are made and taken into income by the recipient.

Discussion Payments made to a retiring or deceased partner in exchange for his interest in partnership property are treated as a distribution by the partnership in liquidation rather than as a distributive share of partnership income or as a guaranteed payment. As such, the distributee partner recognizes gain under the provisions of sec. 731. That is, if such payments are made in cash, as opposed to property, gain is recognized when the cash received exceeds the distributee partner's basis in the partnership. Regs. sec. 1.736-1(b)(6) provides that where the total of sec. 736(b) payments is a fixed sum, a distributee partner may elect to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution in that year and the portion of the adjusted basis of the partner for his partnership interest attributable to this distribution.

The interaction between this section and sec. 734 can create a very complex situation. Under sec. 734(b) a partnership may elect to step-up the basis of the partnership property in the case of a distribution of property to a partner by the amount of any gain recognized by the distributee partner. Hence, if a partner elected to recognize gain under the provisions of regs. sec. 1.736-1(b)(6), the partnership would be adjusting its basis in its property on an annual basis. The annual computations could become a tremendous mechanical burden.

To avoid this situation, we suggest that the partnership be allowed to make this appropriate adjustment under sec. 734(b) in the year the partner retires or dies, based on the total amount to be distributed to him as agreed to by the partnership.

31. Section 741 - Recognition of Limited Gain on Distribution of Partnership in Corporate Liquidation.

Recommendation Sec. 336 should be amended to require recognition of gain on the distribution of a partnership interest in liquidation of a corporation (other than in a sec. 332 liquidation to which sec. 334(b)(1) applies to the extent of the sec. 751 gain (as modified by recommendation 15).

Discussion When a partnership interest is transferred as a result of a corporate liquidation, sec. 751 gain is not specifically an exception to the nonrecognition-of-gain provisions. To the extent that unrealized receivables described in sec. 751(c) were held by the corporation as its own assets rather than in partnership form, it would recognize income on the liquidation distribution. See Jud Plumbing & Heating, Inc.,[1] regarding unrealized receivables and secs. 1245, 1250, 1251, 1252, 1253, and 1254 regarding depreciation and other recapture items. To the extent that the corporation owns inventory described in sec. 751(d), the corporation would not recognize income on the liquidation distribution by the corporation.

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1. Jud Plumbing & Heating, Inc., 153 F.2d 681 (5th cir., 1946).

If a corporation distributes all or a part of a partnership interest, in partial or complete liquidation of the corporation (other than in a tax-free reorganization), then, for the purposes of determining the amount of gain or loss, if any, to be recognized by the corporation and/or the shareholder, and the character of any such gain or loss, the corporation shall be treated as having distributed the proportionate share of each item of partnership property measured by the partnership interest or part thereof distributed.

Similar rules would apply to corporate distributions on which gain is recognized by the corporation under sec. 311.

This recommendation would not be applicable to liquidations relating to tax-free reorganizations.

32. <u>Section 754 - Provide Separate Elections of the Provisions of Section 734 and Section 743</u>.

<u>Recommendation</u> Sec. 754 should be changed to provide for separate elections with regard to choosing to adjust basis of partnership property as provided in sec. 734 and sec. 743. An election to apply the benefits of one of the sections should not be binding with regard to application of the other section. In addition, the election under sec. 743 should be made at the partner level, while the election under sec. 734 continues to be made by the partnership.

<u>Discussion</u> Sec. 734 allows a partnership to adjust the tax basis in its assets generally where a partner is redeemed for an amount different than his tax basis in the partnership. The adjustment under sec. 743 applies where there has been a transfer of a partnership interest and is applicable only to the transferee partner's basis in partnership assets. Other than the fact that the bases of partnership assets are adjusted as a result of these two sections, there is no other relationship between them. It is illogical to tie a redemption of a partnership interest to a transfer by a partner of his interest to a third party.

This election, once made, is irrevocable without the consent of the commissioner. Oftentimes, the computation of the adjustment under sec. 734 is complicated because the redeemed partner may not be sure of his tax basis in the partnership or may not wish to disclose it. If a prior election under sec. 754 had been made to provide a benefit to a new transferee partner, this election could cause a real burden in future years if there is a redemption from a partner not wishing to disclose his adjusted basis in the partnership. A separation of these elections would avoid this potential conflict. Because the election under sec. 743 affects only the basis of the transferee partner, the election should be optional to him and should not be a binding election made by the partnership.

TECHNICAL CHANGES IN THE TREASURY REGULATIONS

33. Regulations Section 1.704-1(d)(2) - Treatment of Charitable Contributions and Foreign Tax Credit Where Limitations Exist on Allowance of Losses.

34. Section 708 - Reorganization Exchanges Not to Be Considered a "Sale or Exchange" for Purpose of the Termination Rule.

35. Regulation Section 1.722-1 - Clarification.

36. Section 731 - Timing of Constructive Distribution Resulting From Reduction in Partner's Share of Liabilities.

37. Regulations Section 1.732-1(b) - Distributions in Liquidation, and Regulations Section 1.732-1(c) - Allocation of Basis Among Properties Distributed to a Partner.

38. Regulations Section 1.736-1 - Payments to a Retiring Partner or a Deceased Partner's Successor-in-Interest.

39. Section 743 - Record Adjustment on Partner's Records.

33. Regulations Section 1.704-1(d)(2) - Treatment of Charitable Contributions and Foreign Tax Credit Where Limitations Exist on Allowance of Losses.

Recommendation The present regulation does not discuss how the charitable contribution or foreign taxes paid by a partnership are to be treated where there is a limitation on the losses deductible in accordance with sec. 704(d).

To clarify the treatment of these items, the agency theory should be applied in these instances. In effect, the partnership is acting as agent for the individual partners by paying the charitable contributions or foreign taxes. Accordingly, these amounts will be treated as a distribution of "cash" from the partnership and a payment of these expenses by the individual partner. The partner will record the distribution of cash in accordance with sec. 733 and sec. 731. Accordingly, because it will exceed his basis in the partnership, the distribution will result in gain. The deduction or credit will be reported on the partner's individual income tax return.

Discussion Regs. sec. 1.704-1(d)(2) requires that the limitation on losses under sec. 704(d) be allocated proportionately to the items described in sec. 702 (a)(1), (2), (3), and (8). It omits reference to the items in sec. 702(a)(4), (5), (6), and (7). Items (5) and (7) are income items and would not be considered limited by the loss. However, item (4) is charitable contributions and item (6) is taxes paid or accrued to foreign countries or U.S. possessions. It could be interpreted that these items pass through to the partner without resulting in gain to him, irrespective of the fact that his share of partnership losses exceeds the tax basis of his partnership interest. To avoid this unintended benefit, the foregoing clarification should be included in the regulations.

34. Section 708 - Reorganization Exchanges Not to Be Considered a "Sale or Exchange" for Purpose of the Termination Rule.

Recommendation In the case of a transfer of a partnership interest when the tax basis of the partnership interest to the transferee is determined by reference to the transferor's basis, no sale or exchange shall be deemed to have occurred for the purpose of determining whether there has been a termination of the partnership under sec. 708(b)(1)(B).

Discussion The law is unclear regarding whether there has been a sale or exchange of the partnership interest when a partnership interest is transferred pursuant to a corporate reorganization, section 332 liquidation, or similar transaction. The regulations except a disposition of a partnership interest by gift (including assignment to a successor-in-interest) and bequests and inheritances from the definition of sale or exchange. The phrase "assignment to a successor-in-interest" standing by itself would seem broad enough to cover reorganizations and similar transactions. However the usefulness of this phrase is limited by the context in which it is placed in the regulations--modifying the word "gift." Accordingly, clarification is needed.

We believe that tax policy and equity would be better served if transactions such as corporate reorganizations would not cause a termination of the partnership. Keeping the partnership intact for tax purposes would be in line with the theory of carryover of corporate attributes under sec. 381.

35. Regulations Section 1.722-1 - Clarification.

Recommendation The examples in regs. sec. 1.722-1 should be expanded to make clear that when a partner contributes property to a partnership that is subject to a mortgage--

1. Where the contributing partner is already a partner, the constructive distribution to him resulting from assumption by the other partners of a portion of the contributing partner's liabilities may be absorbed by the pre-existing tax basis of the contributing partner's partnership interest in addition to the tax basis resulting from the contribution of the property; and

2. When a partner contributes to a partnership more than one item of property subject to liabilities, either in one transaction or in a series of related transactions, the tax bases of the contributed properties and the related liabilities are aggregated in determining whether or not the contributing partner has gain from constructive distribution of money resulting from assumed liabilities.

Discussion Example (2) in regs. sec. 1.722-1 illustrates the tax consequences to a partner who receives a 20 percent interest in a partnership as a result of contributing property with a tax basis of $4,000 and a mortgage of $6,000. The example shows a gain of $800 to the contributing partner. This gain results from a constructive distribution to the partner of $4,800 (80 percent of the $6,000 mortgage), which exceeds the $4,000 adjusted basis of the property by $800. We believe that the example should be expanded to avoid any inference that there would be gain to the contributing partner if the partner already had an interest in the partnership and the preexisting tax basis of his partnership interest exceeded $800. The regulations should also clarify that if, in that example, the partner had, as a part of the same transaction, contributed additional property with a tax basis of $8,000 and a related liability of $9,000, there would be no taxable gain to him, because by aggregating the properties and the liabilities, the constructive distribution to him would not have exceeded the tax basis of his partnership interest. The latter point is illustrated as follows:

	Property A	Property B	Total
Tax basis	$4,000	$8,000	$12,000
Liability	6,000	9,000	15,000
Constructive distribution	4,800	7,200	12,000
Remaining tax basis or distribution in excess of tax basis	(800)	800	0

36. Section 731 - Timing of Constructive Distribution Resulting From Reduction in Partner's Share of Liabilities.

Recommendation Sec. 731 or the regulations thereunder should expressly provide that constructive distributions of money to a partner resulting from a reduction in his share of partnership liabilities shall be deemed to have been made on the last day of the partnership taxable year. An exception to this rule would be provided for relief of liabilities with respect to contributed property.

Discussion We believe that the foregoing recommendation states the existing law; it has been made to avoid any misunderstanding. If the law were otherwise, that is, if it were necessary to look at a partner's share of partnership liabilities on a day-to-day basis, it would be administratively unworkable and would be inequitable in that the partner would suffer the consequences of a constructive distribution from a reduction in share of partnership liabilities without having the corollary benefit of increasing the tax basis on his partnership interest by his accrued share of partnership income (which is taken into account only at the end of the taxable year). See regs. sec. 1.705-1(a).

37. Regulations Section 1.732-1(b) - Distributions in Liquidation, and Regulations Section 1.732-1(c) - Allocation of Basis Among Properties Distributed to a Partner.

Recommendation The regulations should be clarified to include examples of the proper tax treatment when there is a series of distributions in liquidation of a partner's interest over several taxable years.

Discussion Sec. 732(b) provides "the basis of property (other than money) distributed to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest reduced by any money distributed in the same transaction."

Sec. 732(c) sets forth the rules for allocation of basis to various properties received in liquidation. Regs. sec. 1.761-1(d) defines the term "liquidation of a partner's interest" as the termination of a partner's entire interest in a partnership by means of a distribution or a series of distributions to the partner by the partnership. A series of distributions comes within the meaning of the term "liquidation of a partner's interest" even if made in more than one year. The regulations section then refers to sec. 732(b) for the determination of the basis of property distributed in one or a series of liquidating distributions.

The examples under regs. sec. 1.732-1(b) and (c) do not contain any examples of how to treat a series of distributions in liquidation over a period of years. The problems relating to a series of distributions over two years can be illustrated by the following examples:

Example 1. - Partner A, with a partnership interest having an adjusted basis of $12,000, retires from the partnership and receives, for his interest in partnership property, real property with an adjusted partnership basis of $6,000 and a fair market value of $14,000 and cash of $10,000. If the cash and real property were distributed to A in 1976, the tax results under sec. 732(b) would be as follows:

Adjusted basis of A's interest	12,000
Reduction of basis for cash received	10,000
Balance allocated to real property received	2,000

However, if the real property was distributed to A in 1976 and the $10,000 cash was distributed to A in 1977, the following tax results could occur (especially if the taxpayer was not aware that distributions in liquidation can take place over two or more years):

Adjusted basis of A's partnership interest	12,000
Reduction in 1976 for real property distributed (sec. 733); A's basis in real property is partnership's adjusted basis (sec. 732(a))	6,000
Adjusted basis 12/31/76	6,000
Cash distribution 1977	10,000
Gain recognized 1977 (sec. 731(a))	4,000

It is apparent that in example 1, A should not have to recognize any gain merely because the cash distribution was delayed to a later year. Also, A should not be entitled to recognize a loss if the cash received in the final distribution was less than his adjusted basis as computed.

Example 2. Assume the same facts as in example 1 except that, in lieu of the $10,000 cash, A receives a second parcel of real property with an adjusted partnership basis of $12,000 and a fair market value of $10,000. If both properties were distributed to A in 1976, A would allocate his adjusted basis of $12,000 to the parcels, pursuant to regs. sec. 1.732-1(c), as follows:

Parcel 1 (6,000/18,000 x 12,000) =	4,000
Parcel 2 (12,000/18,000 x 12,000) =	8,000
Total	12,000

However, if parcel 2 were distributed to A in 1977, the following different allocation to the properties would occur:

Adjusted basis of A's partnership interest	12,000
Reduction in 1976 for Parcel 1 distributed (sec. 733); A's basis in Parcel 1 is partnership's adjusted basis (sec. 732(a))	6,000
Adjusted basis 12/31/76	6,000
Basis allocated to parcel 2 received in final liquidation of A's partnership interest (sec. 732(b))	6,000
Balance	-0-

The proper tax treatment in example 2 could be further complicated if parcel 2 were depreciable property and partner A could not determine the adjusted partnership basis of parcel 2 until the property was actually distributed.

There are many legitimate business reasons why distributions in liquidation of a partner's interest may take a series of distributions over more than one year. Also, the actual properties to be distributed may not be known when the withdrawal agreement is made. The task force believes it is necessary to amend the regulations to provide examples of the proper tax treatment for a series of distributions in liquidation over two or more years to avoid inconsistencies in tax treatment and possible tax abuses. The task force also recommends that when property distributions take place in more than one year (such as in example 2) and the taxpayer has to determine basis of property received in distribution (for example, for depreciation or sale purposes) prior to receipt of final distribution of property, that the basis be determined pursuant to regs. sec. 1.732-1(a) subject to retroactive redetermination of basis after the final distribution is received.

38. Regulations Section 1.736-1 - Payments to a Retiring Partner or a Deceased Partner's Successor-in-Interest.

Recommendation The regulations pertaining to sec. 736 should be amended as follows:

1. Provide that when cash and property are distributed in liquidation of the interest of a retiring or deceased partner that any payments considered to be made pursuant to sec. 736(a) be considered as having been made--

   (a) First, from unrealized receivables, to the extent of distribution of unrealized receivables in excess of the partner's interest in such unrealized receivables.

   (b) Second, from cash.

   (c) Third, from other property distributed.

2. Provide rules for the distribution of property in satisfaction of sec. 736(a) payments as follows:

   (a) The parties can agree which properties represent the sec. 736(a) payments.

   (b) In the absence of agreement, a pro rata portion of the fair market value of each property distributed will be deemed to be sec. 736(a) payments.

3. Provide that when a sec. 736(a) payment is made with property (other than cash)--

   (a) The amount of the payment under sec. 736(a) shall be the adjusted basis of the property to the partnership.

(b) The basis and character of the property in the hands of the distributee will be determined in accordance with sec. 732.

Discussion Under present rules, distributions of property and cash to a partner in liquidation of the partner's entire interest in partnership property (other than payments for the partner's interest in unrealized receivables and goodwill, under certain circumstances), is considered to have been made in exchange for the partner's interest in partnership property. The payments are treated as distributions from the partnership. Any distributions in liquidation in excess of the partner's interest in partnership property are treated as payments under sec. 736(a). Accordingly, even if there is a single distribution of cash and/or property to a partner in liquidation of his interest, the portion of the fair market value of the distribution in excess of the partner's interest in partnership property at fair market value is considered a sec. 736(a) payment unless the partnership agreement provides for payment for goodwill.

The task force does not believe that the present rule should be changed; however, regs. sec. 1.736-1(b)(5) should be clarified to provide that when such a single distribution takes place, the sec. 736(a) payment should be deemed to have been paid with the following property distributed--

1. First, from unrealized receivables distributed in excess of the partner's interest in unrealized receivables.

2. Next, from cash distributed.

3. Last, any remaining balance of sec. 736(a) payment will come from other property.

The amount so distributed will be the adjusted partnership basis and will be reported on the partnership return as either a sec. 736(a)(1) or a sec. 736(a)(2) payment. The distributee partner would acquire basis in the property to the extent of any income realized under sec. 736(a).

The task force recommends that the regulations provide that the partnership and the retiring partner can agree as to which property is distributed in satisfaction of the sec. 736(a) obligation.

The task force also recommends that if the parties do not agree which property represents the sec. 736(a) payment, the 736(a) payment will be deemed to have been paid from a portion of each property distributed in the ratio of the fair market value of the property distributed to the total fair market value of all property distributed.

The principles set forth are illustrated in the following examples relating to the withdrawal of partner A from the ABCD partnership.

Balance Sheet of ABCD Partnership

	Partnership Basis	Fair Market Value
Assets		
Cash	55,000	55,000
Accounts receivable	30,000	30,000
Depreciable property		
Parcel 1	10,000	30,000
Parcel 2	40,000	30,000
Parcel 3	20,000	45,000
Parcel 4	5,000	10,000
	160,000	200,000
Capital		
A	40,000	50,000
B	40,000	50,000
C	40,000	50,000
D	40,000	50,000
	160,000	200,000

The partnership agrees to distribute to A $60,000 of cash and property for his interest. Accordingly, A will receive a sec. 736(a)(2) payment of $10,000 ($60,000 fair market value of property received less $50,000 value of A's interest in partnership property at fair market value).

Example 1 A receives cash of $15,000 and parcel 3 worth $45,000. A would report $10,000 of cash as ordinary income under sec. 736(a). The balance of $5,000 cash and parcel 3 are distributions under sec. 736(b). Pursuant to sec. 732(b), A's basis in parcel 3 will be $35,000 ($40,000 basis less $5,000 cash received in liquidation).

Example 2 A receives parcels 1 and 2 in liquidation of his interest. The parties agree that $10,000 of distribution of parcel 2 represents the sec. 736(a)(2) payment. The partnership will recognize a loss of $3,333 on the one-third interest in parcel 2 deemed sold to A ($10,000 sales price less $13,333 cost (1/3 of $40,000).) A will receive two-thirds of parcel 2 and parcel 1 in liquidation of his partnership interest. Pursuant to regs. sec. 1.732-1(c), A will allocate his $40,000 basis as follows:

Parcel 1 (10,000/36,666 x 40,000) =	10,909
2/3 parcel 2 (26,666/36,666 x 40,000)=	29,091
Total	40,000

A's holding period for parcel 1 and two-thirds of parcel 2 will be the partnership's holding period. A will have a basis of $10,000 for the one-third interest in parcel 2 acquired as a sec. 736(a)(2) payment, and the date of acquisition of the one-third interest will be the date of distribution of the property.

Example 3 A receives a $15,000 accounts receivable and parcel 3 in liquidation of his interest. The parties did not agree which property constituted the sec. 736(a)(2) payment. The sec. 736(a)(2) payment will be deemed to consist of the following:

Accounts receivable (15,000/60,000 x 10,000 =	2,500
Parcel 3 (45,000/60,000 x 10,000) =	7,500
Total	10,000

The partnership will recognize gain of $4,167 on the distribution of parcel 3 (7,500/45,000 x 25,000).

39. <u>Section 743 - Record Adjustment on Partner's Records</u>.

<u>Recommendation</u> The optional adjustment to basis of partnership property under sec. 743 should be reflected on each partner's books, financial statements, and tax returns and not those of the partnership.

<u>Discussion</u> The code clearly provides that such an adjustment is made with respect to the transferee partner only. There is no substantive reason to reflect such adjustment at the partnership level, and confusion could be avoided if the partner maintained such information. The adjustment is generally complex and can be costly for the partnership to record and maintain. Many publicly held partnerships provide that the election under sec. 754 will not be made by the partnership in view of the bookkeeping problems. Because this election serves a valid purpose, the regulations should clarify that it is not necessary to record the adjustments on the partnership books.

ADMINISTRATIVE AND CLARIFICATION CHANGES

40. Section 704(d) - Clarification of Statutory Language

41. Section 705(a) - Basis of Partner's Interest Should Be Increased by His Tax Basis in Any Capital Contributions to the Partnership.

42. Section 706(b)(2) - Deletion of This Subsection.

43. Section 743 - Provide Question on Tax Form Regarding Section 754 Election.

44. General Administrative Provision.

40. Section 704(d) - Clarification of Statutory Language.

Recommendation The last sentence of sec. 704(d) should be revised to conform with the congressional intent described in the regulations.

Discussion The last sentence of this subsection states as follows: "Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership" /Emphasis added/. The regulations clarify the meaning of this sentence to state that any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

This proposal is merely a "housekeeping" recommendation. It does not appear that the IRS has ever required a loss to be actually repaid to cause it to be deductible.

41. Section 705(a) - Basis of Partner's Interest Should Be Increased by His Tax Basis in Any Capital Contributions to the Partnership.

Recommendation Sec. 705(a) and sec. 722 do not unequivocally state that the basis of a partner's interest should be increased by the tax basis of any capital contributions he makes to the partnership subsequent to the time he acquires his interest. Sec. 705(a) should be amended to add that provision as one of the items increasing the basis of the partner's interest.

Discussion This recommendation is merely a "housekeeping" suggestion. Regs. sec. 1.705-1(a)(2) provides that the basis shall be increased under sec. 722 by any further contributions to the partnership. The task force concluded that language clarifying that subsequent capital contributions are added to basis should be included in sec. 705 or sec. 722.

42. Section 706(b)(2) - Deletion of This Subsection.

Recommendation This subsection, which states that a partner may not change to a taxable year other than that of a partnership in which he is a principal partner without consent of the commissioner, conflicts with regs. sec. 1.442-1(b)(2)(ii). This regulation requires approval of the commissioner for a partner to change his taxable year. The task force recommends that the latter provision be the proper requirement, and that sec. 706(b)(2) be repealed.

Discussion By inference, sec. 706(b)(2) appears to permit a partner to change his fiscal year, without permission, to the fiscal year of any partnership in which he holds a 5 percent or more interest in capital or profits. This interpretation could open the door to tax avoidance. For example, a fiscal year corporation that wishes to change to a calendar year, but cannot satisfy the automatic requirements for changing fiscal years, could acquire a 5 percent or more interest in a calendar year partnership and change its fiscal year to conform to that partnership. While this may be an extreme example and perhaps would not be so interpreted by the courts, the section is confusing and does not serve a useful purpose. The administration of the laws would be better served by requiring the permission of the commissioner for a partner to change his fiscal year.

43. Section 743 - Provide Question Regarding Section 754 Election on Tax Form.

Recommendation A question should be added to the partnership income tax return regarding whether the partnership has ever filed an election under sec. 754.

Discussion The election under sec. 754 is binding on all subsequent years unless permission from the commissioner to revoke it is obtained. To determine if an election has been filed in a preceding year, it may require searching through all prior-year tax returns. This may be impossible if a partnership has been in existance for many years.

To avoid the difficulties in determining whether an election has previously been made, we recommend that the tax form include the question, "Has the partnership ever filed an election under sec. 754?" and the question, "Has permission ever been granted to revoke an election under sec. 754?"

44. General Administrative Provision.

Recommendation Administrative and judicial proceedings with respect to the proposed assessment of deficiencies in income tax related to the operations of a partnership should be handled at the partnership level, with the partnership rather than the partners being the primary respondents in the governmental action.

Discussion Although any deficiency in income tax resulting in an adjustment of partnership income will be assessed against the partners rather than the partnership, for administrative convenience, the partnership should be the primary party responding to proposed adjustments to partnership income at both the administrative and judicial levels.

Provision should be made to recognize authorization in a partnership agreement to permit a designated partner, other than the general partner, to act on behalf of other interests. This would allow negotiation for such a provision in partnership agreements so that a representative of a group of limited partners could contest an IRS determination if the general partner declines to do so.

Requiring each partner to separately contest proposed adjustments creates substantial inefficiencies in disposing of income tax cases involving partnerships. When there are syndications involving hundreds of partners, the administrative problems become almost impossible to cope with. This problem could be resolved by making the partnership the party to the administrative or judicial action. The rights of the partners could be protected by providing that notice of any such action would be given to each partner, and the partners would have the right to intervene in the action.

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